Supreme Court, U.S.
FILED
ALEXANDER L. STEVAS
CLERK

No. 81-523

In The
Supreme Court of the United States

OCTOBER TERM, 1982

CONTAINER CORPORATION OF AMERICA,

Appellant,

v.

FRANCHISE TAX BOARD,

Appellee.

ON APPEAL FROM THE COURT OF APPEAL
OF THE STATE OF CALIFORNIA
FOR THE FIRST APPELLATE DISTRICT

Brief of Jeffrey G. Balkin, James H. Sakoda and Derrick K. Takeuchi Amici Curiae in Support of Appellant

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INTEREST OF THE AMICI CURIAE

The undersigned California attorneys, JEFFREY G. BALKIN, JAMES H. SAKODA and DERRICK K. TAKEUCHI, respectfully submit a Brief Amici Curiae in support of Appellant. Consent of the parties has been obtained from the Attorney General of the State of California and counsel for Container Corporation of America.

The respective law firms of which the undersigned are members have over the years represented taxpayers confronted with proposed unitary tax assessments. Said law firms are currently representing foreign-based multinational companies before state administrative agencies on proposed unitary tax assessments. Attorneys of the firms are Certified Tax Specialists of the State Bar of California who have had experience with practical and legal issues of state taxation in California. As a result of their state and federal practices, said attorneys have gained experience in the international context with the issues involved in this case and desire to contribute to the understanding of the Court on these issues with their far-reaching international ramifications.

A Brief Amici Curiae of the firms was previously submitted to the Court in *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co., Illinois Dept. of Revenue, et al.*, No. 81-349, October Term, 1981, on which this Court heard oral arguments on April 19, 1982. The arguments briefed therein are equally applicable to the case at bar.

SUMMARY OF ARGUMENT

Container Corporation of America is a United States-based multinational. Hence, this case presents the issue, whether the application by California of a worldwide unitary combined income tax reporting method to United States-based multinationals conducting a unitary business violates the Equal Protection, Due Process and Commerce Clauses of the Constitution of the United States. The Court is not called upon to rule on the broader, more internationally sensitive issue of the legality of this taxing method in the context of a *foreign-based* unitary business. The Court is respectfully requested to expressly limit the scope of its ruling in this matter accordingly.

The California worldwide unitary combined tax reporting method does not meet constitutional standards enunciated by this Court because it attributes to California taxable income grossly disproportionate to activities conducted within the State; discriminates against foreign corporations with no constitutional nexus to California; creates an undue administrative burden for taxpayers in defending against assessments; causes material international double taxation; and unduly interferes with exclusive powers of the federal government over foreign commerce and relations.

Although the formula apportionment method which California applies has gained acceptance in the United States in the context of nationwide division of income of a unitary business, it has never been accepted internationally as an appropriate means for the division of income among countries.

ARGUMENT

I.

THE CALIFORNIA WORLDWIDE UNITARY COMBINED TAX REPORTING METHOD CONTRAVENES THE DUE PROCESS CLAUSE BY IMPOSING AN EXTRATERRITORIAL TAX WITHOUT NEXUS TO CALIFORNIA AND WITHOUT EXPLICIT STATUTORY AUTHORITY.

Under the Due Process Clause, a state may not impose a tax generated from interstate commerce unless it has a judicially well-recognized constitutional minimum connection with the taxpayer. *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980); *National Bellas Hess, Inc. v. Dept. of Revenue*, 386 U.S. 753 (1967); *Miller Bros. Co. v. Maryland*, 347 U.S. 340 (1954).

In any exercise of its taxing power, a state must also possess proper jurisdiction to legislate the taxing statute. The Due Process Clause requires, in both the domestic and international contexts, that the limits of jurisdiction must not be transgressed through the mere inference of a taxing power by state revenue authorities from a statute which does not specifically so prescribe. *Cf. Burnet v. Brooks*, 288 U.S. 378, 401 (1933) (Due Process leaves limits of jurisdiction to be ascertained in each case with appropriate regard to distinct spheres of state and nation). Taxing a foreign entity or property without either the requisite statutory authority or nexus to the taxing state represents an unconstitutional attempt to extend a state's jurisdiction beyond the limits of due process. This Court established over a century ago that:

> Where there is jurisdiction neither as to person nor property, the imposition of a tax would be *ultra vires* and void. If the legislature of a State should enact that the citizens or property of another State or country should be taxed in the same manner as the persons and property within its own limits and subject to its own authority, or in any other manner whatsoever, such a law would be as much a nullity as if in conflict with the most explicit constitutional inhibition. *Jurisdiction is as necessary to valid legislative as to valid judicial action. St. Louis v. The Ferry Co.*, 78 U.S. (11 Wall.) 192, 194 (1871) (emphasis added).

Extraterritorial application of California's version of the Uniform Division of Income for Tax Purposes Act and the combined reporting provisions is now at issue before the Court in the case at bar.[1] Under the express pro-

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[1]Cal. Rev. & Tax Code § § 25120-40 (Stat. 1966, ch. 2 § 7)(West 1979) (Uniform Division of Income for Tax Purposes Act); Cal.

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visions of the California tax law, a taxpayer's foreign activities can be taken into account only to a limited extent in calculating franchise tax.[2] Although California apportions income, by reference to taxpayer's worldwide property, payroll and sales,[3] its revenue officials interpret California's tax law as allowing worldwide unitary combined tax reporting based in part on a constitutionally questionable principle, to wit: a multinational unitary business, consisting of separate corporate entities, organized and based in different countries, can be treated as one taxpayer.[4]

The partial operation of a worldwide multi-corporate unitary business within a taxing state does not, *ipso facto*, confer jurisdiction on that state to tax the entire worldwide multinational enterprise on an apportioned basis. In practical terms, the California tax statutes operate so that foreign corporations doing no business in California nevertheless have to report their income and apportionment data for determining the California tax.

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Rev. & Tax Code §§25102 (Stat. 1955, ch. 938, §20, *amended by* Stat. 1959, ch. 273, §3) & 25104 (Stat. 1955, ch. 938, §20) (West 1979) (Combined Reporting).

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[2]Cal. Rev. & Tax Code §23040 (Stat. 1949, ch. 557, § 1) (West 1979) defines *income* by reference to local activities carried on in foreign commerce.

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[3]Cal. Rev. & Tax Code §§25129 (Property Factor), 25132 (Payroll Factor) and 25134 (Sales Factor) (Stat. 1966, ch. 2, §37) (West 1979).

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[4]*Edison California Stores v. McColgan*, 30 Cal. 2d 472, 183 P.2d 16 (1947); *Container Corp. of America v. Franchise Tax Bd.*, 117 Cal.App. 3d 988, 994-95, 173 Cal.Rptr. 121 (1981), *appeal docketed*, _____ U.S. _____, No. 81-523, October Term, 1981 (September 14, 1981); *Max Factor & Co. v. Franchise Tax Bd.*, 35 Cal.App. 3d 7, 110 Cal.Rptr. 536 (1973).

Since most tax jurisdictions, including the United States, do not impose worldwide apportioned income taxes, the overseas affiliates' financial data must be specially developed for the Franchise Tax Board.

This Court recently indicated in *ASARCO Inc. v. Idaho State Tax Commission*, 50 U.S.L.W. 4962, 4968 (U.S. June 29, 1982), that an attempt to tax extraterritorial income must be scrutinized to ascertain if it offends the Due Process Clause as "a mere effort to reach profits earned elsewhere under the guise of legitimate taxation" *citing Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*, 266 U.S. 271, 283 (1924).

The tax provisions upon which California has relied over the years to impose international corporate tax combination are overdue for a rigorous due process examination. As part of this analysis, the Court is urged to strictly construe the California worldwide combined unitary tax reporting statute. "[R]ules of United States statutory law, whether prescribed by federal or state authority, apply only to conduct occurring within or having effect within, the territory of the United States, unless the contrary is clearly indicated." *Restatement (Second) of Foreign Relations Law of the United States* § 38 (1965). *See also Foley Bros. v. Filardo,* 336 U.S. 281, 285 (1949); *Kansas v. Colorado,* 206 U.S. 46, 68 (1906).

The pertinent combined reporting tax provisions, California Revenue & Taxation Code § § 25102 and 25104, do not specifically provide for combining foreign with domestic affiliates. The statutory authority of the Franchise Tax Board to apply combined reporting outside the United States cannot be merely inferred from the statute. Explicit statutory language, which does not currently exist, is necessary before California revenue authorities can tax

multi-corporate international activities.[5]

II.

WORLDWIDE UNITARY COMBINED TAX REPORTING IMPOSES UNCONSTITUTIONAL INTERNATIONAL MULTIPLE TAXATION.

A constitutional defect in California's franchise tax, as applied to such domestic-based multinationals as Container Corporation of America, Caterpillar Tractor Company and Chicago Bridge & Iron Company[6] *and* to such foreign-based multinationals as Shell Petroleum N.V.[7], Alcan Aluminum Limited[8] and EMI,

[5]An example of statutory language explicitly defining the authority to tax on an extraterritorial basis is the "contiguous country" exception to the general "water's edge" approach of federal combined return taxation in Internal Revenue Code §1504(d). This Code section defines the conditions under which a foreign corporation may be treated as a domestic corporation for federal tax purposes.

[6]*Caterpillar Tractor Co. v. Lenckos*, 84 Ill. 2d 102, 117 N.E.2d 1343 (1981), *cert. granted sub nom. Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, ____ U.S. ____, 102 S.Ct. 564 (1981), No. 81-349, October Term, 1981 (September 14, 1981). Chicago Bridge & Iron Co. appealed in its posture as an intervenor and the record contains no facts regarding Chicago Bridge. Neither Caterpillar Tractor Co., the taxpayer, nor the Illinois Department of Revenue appealed the decision of the Illinois court. Chicago Bridge intervened as a plaintiff challenging the constitutionality of the Illinois system of worldwide combined unitary tax reporting.

[7]*Shell Petroleum N.V. v. Franchise Tax Bd.*, No. C 81-4302 MHP (N.D. Cal. filed Nov. 4, 1981) is pending in the United States District Court, Northern District of California.

[8]*Alcan Aluminum Ltd. v. Franchise Tax Bd.*, 81 Civ. 3911 (GLG) (S.D.N.Y. filed Dec. 3, 1981) in the United States District Court, Southern District of New York, has been stayed to await decision in the case at bar and *Anaconda v. Franchise Tax Bd.*, No. 1-48666 (Cal. Ct. App. filed March 24, 1982); *Firestone Tire &*

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Inc.[9] (all of whom are subject to worldwide combined reporting in California), is the inherent risk of international double taxation.

In *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 450-51 (1979), the Court found the multiple tax unconstitutional in large part based upon two factors. First, Japan, taxpayer's commercial domicile, fully taxed the cargo containers in question without any apportionment. Thus, any tax by California over and above the Japanese tax constituted a multiple tax. Second, Japan's practice was not only justified under concepts of jurisdiction and international law, but it was the predominant practice among nations. The Court found that California's practice of taxing containers of a foreign shipper was a clear departure from the international norm.

In the case at bar, the State of California is similarly asserting a method of taxation, this time over multinational groups of companies, which is completely out of step with international practice.[10] The threat of retaliation and

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Rubber Co. v. Franchise Tax Bd., No. 2-62918 (Cal. Ct. App. filed 1981); *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, ____ U.S. ____, No. 81-349, October Term, 1981 (September 14, 1981); and *Alcan Aluminum Corp. v. Franchise Tax Bd.*, C196604 (Los Angeles County Super. Ct. filed April 15, 1977).

[9] *Capitol Industries-EMI, Inc. v. Bennett*, No. 80-4114 (9th Cir. 1982) (*remand pending*, with order to dismiss the case of the U.S. subsidiary, Capitol Industries). The Ninth Circuit ruled on February 16, 1982 that California's system of worldwide combined unitary taxation does not provide a state remedy for foreign corporations to challenge assessments against their domestic subsidiaries.

[10] *See Tax Treaties with The United Kingdom, The Republic of Korea and The Republic of the Philippines: Hearings Before the Senate Foreign Relations Comm. on Tax Treaties*, 95th Cong., 1st Sess. 20-21 (July 19, 20, 1977) (Statement of Assistant Treasury Secretary Laurence N. Woodworth). Dr. Woodworth stated: "The

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multiple taxation under worldwide combined reporting is at least as serious, and at least as potentially disruptive to international commercial relations, as it was in the case of the multiple property tax on containers in *Japan Line*.[11] As this Court indicated in *Japan Line*, while a low level of double taxation in a purely interstate context is an acceptable price to pay for preserving state diversity, such is not the case where commercial relations with foreign nations are involved. In foreign commerce, "[e]ven a slight overlapping of tax—a problem that might be deemed *de minimis* in a domestic context—assumes importance when sensitive matters of foreign relations and national sovereignty are concerned." 441 U.S. at 456. *See also* L. Henkin, *Foreign Affairs And The Constitution*, 237 (1972).

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Federal Government and virtually all the other governments in the world determine taxable income on the basis of what are arm's length transactions in dealings between related companies. This is the general rule. . . .I think the most serious problem in using the unitary system abroad is the fact that the arm's length rule is generally applicable in the world today. . . ."

[11] Admittedly, *Japan Line* involved property taxes, and therefore in *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980) the Court was unwilling to extend its multiple tax analysis in *Japan Line* to the Vermont tax. *See also Transcript of Oral Arguments Before Supreme Court of the United States* at 41 *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, No. 81-349 (____ U.S. ____, 102 S. Ct. 564 (1981), No. 81-349 (U.S. argued April 19, 1982). Nevertheless, it is appropriate to extrapolate from the *Japan Line* holding to this case since the California unitary concept which the Court describes in *ASARCO, Inc. v. Idaho State Tax Commission*, 50 U.S.L.W. at 4965 as the "linchpin of apportionment" was itself derived from property tax law. California UDITPA Apportionment Manual ¶ 0300 (1977) states: "The 'unitary' business concept was derived from real property tax law, which applied what was known as the 'unit' rule. This rule was first approved in the case of *Union Pacific Ry. v. Cheyenne*, 113 U.S. 516 (1884)."

A constitutionally unacceptable double tax burden on international commerce results in significant part from California's practice of treating net income before foreign income taxes as the apportionable tax base for worldwide unitary combined tax reporting purposes.[12] (California, unlike most other taxing jurisdictions including the United States, does not provide income tax deferral for separately incorporated overseas operations.) To eliminate this virtual certainty of multiple taxation, California and other worldwide unitary combined tax reporting States[13] should be required by this Court, at a minimum, to compute tax on worldwide combined net income after allowance for foreign income taxes.[14]

[12]Cal. Rev. & Tax Code § 24345(a)(2) (Stat. 1955, ch. 938, § 20, amended by Stat. 1957, ch. 544, § 5) (West 1979) provides that nondeductible federal income taxes include foreign income taxes imposed at the national level.

[13]General Accounting Office (GAO), *Report to the Chairman, House Committee on Ways and Means, Key Issues Affecting State Taxation of Multijurisdictional Corporate Income Need Resolving*, 66, Appendix II, July 1, 1982. The GAO Report identifies those states which apply worldwide combined unitary tax reporting to corporations.

[14]This might require California to grant a provisional tax deduction or credit recapturable to the extent federal tax benefit is later allowed for the foreign taxes levied upon the combined income or alternatively, for administrative convenience, California could compute tax merely using after-tax rather than pre-tax net income. Cal. Rev. & Tax Code § 23057 (Stat. 1955, ch. 938, § 7) (West 1979) provides that if any portion of California's Bank & Corporation Tax Law is held unconstitutional, "such determination shall not affect the remainder of this part, nor, will the application of any such provision to other persons, taxpayers or circumstances, be affected thereby." Thus, this Court may deem a portion of California's tax statute unconstitutional and order the tax to be computed on combined net income after allowance for foreign income taxes without invalidating the entire statute.

The above-described approach is not inconsistent with this Court's

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III.

THE CALIFORNIA WORLDWIDE UNITARY COMBINED TAX REPORTING METHOD, AS APPLIED, VIOLATES THE DUE PROCESS AND EQUAL PROTECTION CLAUSES OF THE FOURTEENTH AMENDMENT TO THE UNITED STATES CONSTITUTION AND BURDENS FOREIGN COMMERCE.

The constitutional requirement of even-handed law enforcement is applicable to tax measures. *Sioux City Bridge Co. v. Dakota County*, 260 U.S. 441 (1922); *Home Telephone & Telegraph Co. v. City of Los Angeles*, 227 U.S. 278 (1913); *Raymond v. Chicago Union Traction Co.*, 207 U.S. 207 (1907).

California's extension of unitary combined tax reporting to include overseas affiliates discriminates against businesses operating internationally (as opposed to intranationally) especially those with foreign ownership. This discrimination stems from the gross distortion, *i.e.*, disproportionate taxation relative to the level of in-state activity or income, caused by application of this taxing method beyond U.S. borders.[15] Further, foreign affiliates doing no business in California are forced to combine their tax-adjusted financial results with those of related domestic companies. The concomitant heavier administrative

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pronouncement in *Mobil*, 445 U.S. 425. This method is basically a "source" rule which meets the requirements in *Mobil* to adequately determine what income does or does not have a foreign source. In the context of unconstitutional double taxation, there should be no distinction between "allocated" versus "apportioned" methods of sourcing income.

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[15] "Such methods [i.e., worldwide combined reporting] would necessarily be arbitrary, tending to disregard market conditions as well as the particular circumstances of the individual enterprises in tending to

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and fiscal burden placed upon international business in initially supplying financial statements and records and subsequently identifying, quantifving, and supporting essential tax adjustments in an attempt to avoid such distortion is *per se* discriminatory. This burden is an unacceptable impediment to foreign commerce. *See* General Accounting Office, *Report to the Chairman, House Committee on Ways & Means, supra* note 13, at 37-40; Cal. Rev. & Tax Code Regulation §25137(m) (codifying administrative practice, approval pending before California Office of Administrative Law).

Whether or not this heavier burden on foreign commerce was intended by the California legislature or Franchise Tax Board is irrelevant. A tax which is discriminatory in effect is nonetheless unconstitutional even where "the unequal operation of the taxing system was due to inadvertence rather than design." *F.S. Royster Guano Co. v. Virginia*, 253 U.S. 412, 415-16 (1920). The Court has recognized a constitutional exception to formula apportionment in state taxation whenever the result is unworkable or unfair. *Norfolk & Western Railway Co. v. North Carolina*, 297 U.S. 682 (1936); *Hans Rees' Sons v. North Carolina*, 283 U.S. 123 (1931).

California justifies extending its domestic tax method internationally on the erroneous assumption that a three factor formula, "while not perfect, reflects more accurately

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ignore the managements own allocation of resources, thus producing an allocation of profits which may bear no sound relationship to the economic facts and inherently running the risk of allocating profits to an entity which is in truth making losses. . . ." *Organization for Economic Cooperation and Development Fiscal Affairs Comm. Report, Transfer Pricing and Multinational Enterprises* 14-15 (1979). *See also State Taxation of Foreign Source Income; Hearings on H.R. 5076 Before The House Ways and Means Comm.*, 96th Cong., 2d Sess. 3, 4 (March 31, 1980) (Statement of Assistant Treasury Secretary Donald C. Lubick).

the realities of the business and tax world." *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 282 (1978) (Blackmun, J., dissenting). The three factor formula typically fails to take into account the considerably greater economic diversity worldwide than domestically.[16] The United States cannot tolerate any state tax apportionment method that discriminates against and burdens foreign commerce by calculating the tax liability of a multinational corporation based upon rough approximations and not upon more precise economic formulations. *See International Harvester Co. v. Evatt, Tax Commissioner*, 329 U.S. 416, 422 (1947). This burden is even more intolerable when the Court considers the voluminous data about overseas affiliates' activities exacted from taxpayers by California tax authorities. While such approximations and adher-

[16]"Moreover the operations carried on in foreign countries may be very different from those conducted in the U.S. Thus, in industries that depend on natural resources, the underdeveloped low-wage countries are frequently the source of the basic raw materials used in the industry, whereas the high-wage industrialized countries do the manufacturing. Hence, the wage and property costs in the two sets of countries are not comparable, since they relate to different operations. Furthermore, foreign markets may require the manufacture and sale of different qualities, grades or character of products in the same industry, from those made and sold in the U.S." J. Hellerstein, *Allocation and Apportionment of Dividends and the Delineation of the Unitary Business*, 14 Tax Notes 155, 164 (1982).

A Commissioner's Note to Uniform Division for Tax Purposes Act (UDITPA) §11 (Property Factor), 7A *Uniform Laws Annotated* 102 (West 1978) states: "This section is admittedly arbitrary in using original cost rather than depreciated cost, and in valuing rented property at eight times the annual rental. This approach is justified because the act does not impose a tax, nor prescribe the depreciation allowable in computing the tax, but merely provides a basis for division of the taxable income among the several states. The use of original cost obviates any differences due to varying methods of depreciation, and has the advantage that the basic figure is readily ascertainable from the taxpayer's books. No method of valuing the property would probably be universally acceptable."

ence to a three factor formula may be tolerable in an economically homogeneous domestic context, it is totally unacceptable in the more complex and sensitive global community. *See Japan Line*, 441 U.S. at 456.

Taxpayers and tax collectors alike suffer from the lack of comprehensive guidelines necessary to effectively resolve the distortion issue in the international context when worldwide unitary combined tax reporting is employed. This Court recognized in *Hans Rees'* that "evidence may always be received which tends to show that a state has applied a method, which, albeit fair on its face, operates so as to reach profits which are in no just sense attributable to transactions within its jurisdiction." 283 U.S. at 134. Moreover, in *Norfolk*, 297 U.S. at 685, the Court pointed out that those primarily concerned with state taxation cannot be left without practical aids of ready application.

The approach in *Norfolk* is indicative of the Court's sensitivity to the impact of geographically divergent economic conditions. Although *Norfolk* involved domestic tax apportionment, the Court suggested an approach to resolve the distortion issue which may be applicable to apportionment on a worldwide basis. Adjustments to the normal three factor apportionment formula (which California and other unitary states reluctantly allow)[17] is appropriate where there is higher than average in-state operating costs relative to lower than average in-state sales. Situations, for example, such as start up operations, where the unitary ties to an overseas affiliate often appear to be the strongest, will benefit from this approach, thus alleviating some of the burden on foreign commerce.

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[17]*See* Hellerstein, *supra* note 16, at 155.

Until the *Container* and *Chicago Bridge* cases, the Court has had no real opportunity to consider the distortion issue in a multiple corporate international context. This Court is urged to fashion sorely needed guidelines for taxpayers, state revenue authorities and courts to test for constitutionally unacceptable distortion in international unitary situations.

CONCLUSION

This Court is respectfully urged to reverse the ruling of the California Court of Appeal. In the event the Court affirms the California court, it is urged to expressly limit its ruling to tax reporting methods as applied to United States-based multinationals.

Respectfully submitted,

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ss.

County of Los Angeles

I, the undersigned, say: I am and was at all times herein mentioned, a citizen of the United States and a resident of the County of Los Angeles, over the age of eighteen (18) years and not a party to the within action or proceeding; that my business address is 3340 Ocean Park Boulevard, Suite 3005, Santa Monica, California 90405: that on July 30, 1982, I served the within *Amici Curiae in Support of Appellant* in said action or proceeding by depositing true copies thereof, enclosed in a sealed envelope with postage thereon fully prepaid, in the United States mail at Santa Monica, California, addressed as follows:

Alexander L. Stevas
Clerk, Supreme Court of the
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Washington, D.C. 20543
(Hand delivered: 40 Copies)

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I declare under penalty of perjury that the foregoing is true and correct. Executed on July 30, 1982 at Santa Monica, California.

Kirk W. Harney
(Original signed)